# NEW RULES FOR EMU?

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## 1 An improved framework

The euro is a radically new project, for which there was no ready-made blueprint. The original Maastricht assignment has been shaken by the crisis. Europe has put together an impressive policy response, albeit with difficulties. Now that the acute symptoms of the financial crisis have abated, it is timely to take stock of progress in reforming the architecture.

A fundamental insight from Maastricht remains. Monetary policy can only reach its stability objectives if it enjoys fiscal backing (as emphasised early on by Sargent and Wallace, 1981). In a monetary union, that creates an obligation for all members to pursue fiscal discipline. The Maastricht architects were keenly aware of this fact. But they did not wish, or felt they could not, encroach much on national fiscal sovereignty. So fiscal rules were introduced in Maastricht, and further developed in the SGP, in order to constrain national behaviours that remained supposedly sovereign.

As we know, the Maastricht compromise underwent a series of problems. One important aspect is the design of fiscal rules: they have been charged with being either too lax (in good times) or too stringent (in bad times). Another long-standing issue is weak enforcement mechanisms. But the crisis brought to the fore previously unsuspected problems as well. Notably, massive contingent fiscal risks emerged from the private sector, especially the financial sector. And sovereigns of a monetary union with freely moving capital could be exposed to just the kind of liquidity stops that were thought to be the lot of emerging markets.

The package of steps taken over the past few years is substantial:

a) Fiscal governance has been refurbished, albeit in an "incremental" manner. This is the trilogy Six pack/Two pack/Fiscal Compact. In a nutshell the attempt is to have smarter rules, stronger enforcement and deeper national ownership. Surveillance has also been broadened with the macroeconomic imbalances procedure.

b) Banking union is a potential game changer. The single supervisory mechanism should help prevent the building up of excessive risk, while the provisions for resolution, including bail-in and a degree of pooling, should protect taxpayers and help cut feedback loops.

c) Financial safety nets have been developed. These include the European Stability Mechanism, but also the Outright Monetary Transactions (OMT) programme. It may also be worth mentioning the TARGET2 system (though not an innovation from the crisis), which has acted as crucial buffer of BoP adjustment (Bretton Woods did not have a TARGET, as noted by Bordo, 2014).

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## 2 Open questions

The question we are faced with today is whether we now have an architecture that is “fully fit”. The answer is that we are probably not yet there. The remaining open questions include:

a) The design of the rules, again. They are smarter but said to be too complex. And maybe still too pro-cyclical, in bad times (Blanchard and Leigh, 2013) but also in good times. This is all the more important that the macroeconomic impact of fiscal policy as shock absorber has increased importance in a monetary union.

b) The relationship between fiscal and economic surveillance. It has been noted that deep reforms, which are indispensable to guarantee sustainability, often take time to bear fruits and may present short-run costs, though not always. What are the pros and cons of a trade-off between fiscal flexibility and structural reforms? In particular, how can we overcome the information asymmetry which makes a deal based on the promise of bolder reforms very difficult to enforce (can contractual arrangements be the answer)?

c) The question of enforcement remains work in progress. The two-pack has given the centre some greater weight, by introducing an ex ante look at national budgets. But the final say remains in national hands. And some observers insist (Wyplosz, 2013; Mody, 2013) that the Stability and Growth Pact collides with the de facto prevalence of national politics. Meanwhile, the Fiscal Compact has introduced a complementary but also potentially competing track, where enforcement is delegated to national control institutions.

d) The possible under-provision of risk-sharing in current EMU. One paper of the previous session argues that “macroeconomic” forms of risk-sharing are unworkable because of problems in assessing real-time business cycles. It says the route is shifting microeconomic competences to the centre, such as pensions, which would also increase area-wide insurance mechanisms. Perhaps, but this is really very long term. Better private risk-sharing is also worth exploring (“more equity, less debt”), as it may not face the same political opposition.

e) The ability to overcome the “debt overhang”. This is an over-riding challenge today, and in fact one that poisons the rest of the discussion on the architecture. In terms of the economic outlook, things are getting a bit better in the EU economy, but we know that the road is long for better flows to translate into better stocks. Some influential observers are advocating more radical policies.

There is overall an interrogation about the very direction of institutional reforms: shall we head towards more centralisation or some decentralisation? More of common tools, or a return to strict policy of no bail out? There are conflicting views on these matters.

## 3 The way forward

One path suggested in the debate is putting more emphasis on market discipline. This proposal starts from the presumption that fiscal policy is a national business and will remain so. Therefore, only a credible no bail out system can create the right incentives for discipline. This approach is a big gamble though. For one, it assumes that we would not face a “too big to fail” issue when it comes to sovereigns. And it leaves smaller sovereigns at the mercy of the whims of markets. One says it works for US states but the setting is massively different: US states have small budgets and debts in comparison to EU states, and there is a big centre. The comparison is flawed. This is not to say that market discipline has no role to play whatsoever in EMU, but whether it can be its very cornerstone is a different matter.

The Commission Blueprint (European Commission, 2012) did lay out a different sense of direction. It made the case for further common tools, including CCI, a fiscal stabilisation tool,

possible further interference on national budgets and Eurobonds. But traction has somehow been eroded as we got out of the acute phase of the crisis, while some progress was achieved on the banking union front. We need to keep some momentum, even if we depart from the specific prescriptions of the blueprint.

In general all proposals need to consider their compatibility with the EU legal framework. What can be achieved within the current Treaty and what would require a Treaty change? The Blueprint made clear that some of the profound changes would require an evolution in EU primary law. International agreements can at best be a temporary patch, and at worse create legal hydras.

Today it is absolutely essential to continue restoring the credibility of our public finances. The situation is fragile. Markets are benign today but may not be forever, even with OMT. Member States, starting with the big ones, bear a huge responsibility in pursuing the path of reform, especially now that the economic prospects are slowly improving. Restoring trust in banking systems is also vital. The most topical issue is arguably how to carry out in a low-inflation environment the needed deleveraging, in particular, how to respect the debt rule for the public sector. Would there be a risk of monetary dominance in such a situation (overburdening fiscal policy, so somehow turning Sargent and Wallace on its head)?

Meanwhile, institutional changes to address the remaining weaknesses of our architecture will need to resume at some point, e.g. once conditions of a “veil of ignorance” are re-instated. For the fiscal framework, one may have to think in terms of simplifying the rules and giving them sound economic content. That would assume overcoming the curse of the “complete contract” which has led to an over-engineering of the fiscal rules. It would imply finding a consensual balance between mechanical rules and economic judgement, not an easy assignment. One would also need to strike the right balance of competences between the national and EU dimensions.

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